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SUBJECT: KAZAKHSTAN MANAGING REVERBERATIONS OF THE U.S. SUBPRIME
CRISIS

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11. (SBU) Summary. The global reverberations of the subprime mortgage crisis in the U.S. have not passed Kazakhstan by. Though most observers believe that the impact of the current turbulence will be limited and not threaten the country's long-term economic prospects, there are nevertheless shorter term challenges. In particular, while the banking sector remains stable and the effects on the broader economy have been largely muted, the real estate and construction sectors have taken a hit. On a more positive note, the global financial turbulence has staunched a liquidity glut in Kazakhstan's banking system, forcing a financial readjustment that may actually be beneficial. More problematic for the country, perhaps, is a significant uptick in inflation, which is posing dilemmas for policymakers and taking on decidedly political overtones. The tenge remains stable, though the Central Bank recently had to draw down reserves by several billion dollars to support the currency in the face of significant downward pressure. End summary.

The Financial Crisis: From Middle America to Kazakh Steppe

12. (SBU) Kazakhstan's banking sector has taken a hit from the U.S.-inspired global financial turbulence, but remains stable. While Kazakhstan's major banks do have significant exposure to the domestic real estate sector, the Chairman of the Financial Supervision Agency (FSA), Arman Dunayev, recently told the Ambassador that because Kazakhstan does not have a domestic subprime mortgage market, the country's only link to the global financial crisis is via its banking system's external borrowings. These external borrowings by Kazakhstani banks mushroomed over the past two years, attracting substantial notoriety (ref A) and resulting in the country's financial system developing a dependence on a continuing inflow of liquidity from abroad. According to most informed observers, these borrowings had created an unhealthy liquidity glut.

The Banking Sector: How Painful the Moment of Reckoning?

13. (SBU) The global financial crisis has dried up global liquidity, and interrupted Kazakhstani banks' external borrowing binge. This has helped prevent further aggravation of liquidity-driven imbalances in Kazakhstan. As Anvar Saidenov, Chairman of the National Bank of Kazakhstan (NBK, the country's central bank), stated to the Ambassador on August 15, "we actually wanted to slow down the credit activity of the banks, even perhaps the economy

itself."

14. (U) With Kazakhstani banks suddenly finding themselves unable to continue their binge of borrowing from abroad, some questions have arisen about their ability to service their external debts. For example, on October 9 Fitch Ratings downgraded the debt of Kazakhstan's three leading commercial banks; Moody's followed suit three weeks later with six downgrades. According to the NBK statistics, net external borrowings of Kazakhstani banks were, as of September, \$23.6 billion. Debt service payments due by the end of year were \$3.8 billion. Nevertheless, key actors in the Kazakhstani banking sector have sounded reassuring, indicating that the debt service payments are not a substantial burden. Central Bank chairman Saidenov has publicly stated that the banks are "capable of handling the situation themselves."

15. (SBU) In addition, Magzhan Auezov, Managing Director of KazKommertsBank, told the DCM on October 3 that most of the Kazakhstani banks' external debts are in the form of syndicated loans, not bonds. Thus, Auezov claimed, their terms can more easily be renegotiated. According to Saidenov, the primary risks appear to reside in the smaller banks, not the leaders. On the other hand, FSA Chairman Dunayev told the Ambassador, smaller banks did not participate in the external borrowing binge. In any case, the NBK and the FSA are not taking any chances. In order to strengthen the banking system's financial footing, the regulators have raised reserve requirements. "Other countries' central banks are adding liquidity; we are taking it out," Dunayev said. He stressed the regulators' resolve to do what is needed to avert a deep banking sector crisis: "If something happens," he said, "clearly the NBK will have to use gold reserves to help our banks to repay their debts."

Construction Sector Hit, Real Estate Market Cooling

16. (SBU) With securities markets woefully underdeveloped, much of

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the banking system's excess liquidity had been pouring into the domestic real estate market, through both mortgage lending and construction financing provided by banks. In turn, the real estate sector, particularly in Astana and Almaty, had been showing worrying signs of overheating.

17. (SBU) While the impact of the global crisis on the overall Kazakhstani economy has so far been muted, it has hit the real estate and construction sectors. Some Kazakhstani banks have since cut back sharply on their mortgage lending, particularly for housing developments in the new parts of Astana. As a result, interest rates on (tenge-denominated) mortgages have soared from 14-15% before the crisis to 21-22% now. Reports abound of work on many construction sites in Almaty and Astana having been suspended. While there are no reports of mass defaults of mortgages, a cooling in the real estate market is evident. Although housing prices in Almaty and Astana are still up sharply year-on-year, they currently appear to be receding in Almaty and stagnating in Astana.

When It Rains, It Pours... Inflation Breaks out

18. (SBU) It is not the banking sector, however, but the inflation that is currently capturing Kazakhstani headlines. With monthly inflation soaring from 0.7% in August to 4.4% in October (and year-on-year inflation rising in the same period from 9.4% to 15.3%), the outbreak is significant and attracting a lot of attention. The political ramifications of the uptick are magnified by a disproportionate rise in bread prices specifically (ref C) and food prices in general. Despite obvious links to rising wheat prices on the world market, the growth in bread prices - and food prices overall - is taking on increasingly political overtones. At an October 12 conference, President Nazarbayev stated that "somebody is trying to destabilize the economic situation in the country." This remark comes in the wake of the government's repeated pronouncements blaming monopolies, working in tandem with corrupt akims, for the spike in inflation.

¶9. (SBU) There may, however, be tangible economic roots of the rising inflation. Possible contributors include the effects of the mushrooming (pre-August) liquidity glut, fiscal loosening in the run-up to the August Parliamentary election, and delayed post-election hikes in government-regulated utility tariffs. Furthermore, the relative lack of competition in Kazakhstan's economy, especially at wholesale level (and particularly in the food industry) may be acting as a significant magnifying mechanism for external inflationary pressures, a phenomenon quite pronounced in the current growth of food prices.

Save the Tenge

¶10. (SBU) During the recent U.S.-inspired economic turbulence, the tenge has remained quite stable against the dollar. (Note: After trading in the 123-126 KZT/\$ range in August, the tenge has not since ventured outside the 120-122 range. End note.) This stability, however, belies some substantial downward pressure on the tenge, which prompted the NBK to undertake an apparently gargantuan effort to support the domestic currency. Speaking to the DCM, Auezov attributed recent pressure on the tenge to two causes. One was a panic sell-off due to the very brief stoppage of the inflow of foreign currency into Kazakhstan due to a customs shutdown. (Note: The foreign currency portion of customs shutdown (ref D, E) led to a brief panic-buying of dollars by the Kazakhstani public during late August and early September, but was resolved within days. End note.) The second reason, said Auezov, is the end, brought about by the American financial crisis, of the dollar-to-tenge carry trade. According to Auezov, Morgan Stanley had a tenge-denominated position worth \$1.2 billion, which it quickly unloaded when the troubles in the U.S. began. The NBK, Auezov added, ended up supporting the tenge on the open market, "selling \$800 million on a single day." (Note: official data supports this. During the August to September period, the NBK's gold and foreign reserves fell from \$22.0 billion to \$18.5 billion. End Note.) Dunayev told the Ambassador that if the NBK had not stepped in to drain the liquidity, "inflation would have been even higher."

Comment

¶11. (SBU) With the National (Oil) Fund still flush with petrodollars, and foreign reserves still strong, the National Bank of Kazakhstan remains in a firm position to ward off any truly serious banking system crisis. In fact, as noted above, the sudden drying up of global liquidity may, in the long term, be good for Kazakhstan's financial system, by helping to resolve imbalances

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driven by the liquidity glut. Concurrent rising inflation may, in the end, prove to be the more turbulent factor. If it searches for a quick fix to the inflation problem, the government could end up introducing measures that have little to do with the economics of the phenomenon. The National Bank's steady hand on the monetary policy and resolve to control liquidity may itself be sufficient to bring the inflation spike under control. End comment.

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